THE DOUBLE BOTTOM LINE

Remarks by State Treasurer Philip Angelides to the
California Association of Public Retirement Systems
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I am delighted to be here today to share with you some of my thoughts about the challenges facing California and to talk with you about the important role which investment capital can play in contributing to the wealth and strength of our society.

Last June, the Treasurer's Office released a report that we called *Smart Investments*. In it, we articulated a state investment policy to meet the challenges California will face over the next two decades as it adds 12 million new residents, four million new households, and more than two million additional children to the public school system.

In that report, we outlined two overarching challenges that we must overcome in order to sustain economic success well into the 21st Century. First, we said that we must find a way to meet the tremendous demands of this projected population growth while preserving those unique environmental qualities that have always made California an attractive place in which to live and work.

> "A high quality of life," according to the Center for the Continuing Study of the California Economy, "is increasingly a determinant in attracting entrepreneurs and workers in global industries. Failure to protect the natural attractiveness of California can, therefore, hurt the state's prosperity."

Here are a couple of examples of ways that today's growth patterns increasingly threaten California's environmental quality and livability.

- Because of our development patterns, Californians wasted more than 800,000 hours per day sitting idle on congested highways last year. Traffic congestion not only costs billions of dollars in lost economic productivity, it's a primary cause of the state's poor air quality. Eight of the nation's 15 worst air quality basins are here in California!

- The lack of affordable housing is another example of the negative consequences of our growth patterns. Since 1995, we have created 3.2 jobs for every one new housing unit and California now has 13 of the nation's 25 least affordable housing markets.

The second major challenge which we noted in our report last June is to accommodate growth in ways that promote equality of opportunity across our State. Put differently, it will not be possible to maintain our economic strength in future decades if there are "two Californias" – with some parts of the State experiencing a buoyant economy while simultaneously there are communities suffering from economic decline and devastation.

Centuries ago, Aristotle observed that poverty – the absence of a shared stake in society – was the greatest threat to democracy. More recently, Federal Reserve Chairman Alan Greenspan has cited income inequality as a threat to our nation's security.

The conventional wisdom is that we are enjoying an economic boom of historic proportions. This State has the seventh largest economy in the world. Yet in East Palo Alto and Salinas, in Compton and Bell and Huntington Park in the Los Angeles area, in the San Joaquin Valley and in the Del Paso Heights area of my hometown of Sacramento, times are not so good.

For all of our successes, California has the greatest gap between rich and poor of all but four states in this country, and the number of Californians living below the poverty line grew by 28 percent between 1989 and 1996. Real incomes for the poorest 20 percent of Californians dropped by 10 percent in the 1980s, while incomes of the wealthiest five percent rose by 18 percent.

The evidence makes it increasingly clear that preservation of the environment and promotion of equality of opportunity are significant long-term challenges to our economic future.

Accordingly, the policies I have pursued have been guided by these two goals – sustaining and enhancing our quality of life and broadening economic opportunity for the California left behind. In the public programs I administer as Treasurer – financing for affordable housing, small business lending, and assistance for community health clinics, to name a few – we have redirected program resources to meet sustainable development goals and to bring economic ballast to the communities struggling hardest.

And as the State's chief investment officer, I am posing the following question: Are there ways that we can prudently deploy the state's investment capital in a manner that is fully consistent with my fiduciary responsibility to achieve good returns, at the same time that we promote more environmentally responsible patterns of growth and bring greater economic opportunity to the neighborhoods and sectors of our society that have been left behind in the boom? Some would say that we need to choose between our fiduciary responsibility and doing the right thing. But I say that the two can be one and the same.

In the end, if we allow our quality of life to diminish and if we have a large and growing underclass in this State, it will undermine us economically. And that will have a direct effect on our State's investment portfolio. These are matters about which a chief investment officer must be concerned.

As Treasurer, I sit on the boards of the Public Employees' Retirement System - CalPERS - and the State Teachers' Retirement System - CalSTRS, and I chair the board that directs the investments of the State's short-term fund, the Pooled Money Investment Account. All told, those three pools have more than $300 billion in capital.

In my first 15 months as Treasurer, I have been working hard to manage and invest the State's portfolio in a way that is financially prudent and that gets good returns – everything you would expect of someone who is charged with protecting the funds of pensioners and taxpayers.

And I have been seeking to invest in ways that move our society forward and that create economic wealth and productivity.

If we make investments that are sound from a fiduciary standpoint and if those investments also promote environmental protection or equality of opportunity, we will have what I call a “double bottom line” return. It’s not a matter of a choice between investing to make money or investing to do “good” things. It’s a matter of taking the time and making the effort to find investments that do both.

At this point, I want to talk to you about an early example of good “double bottom line” investment policy – an almost perfect blend of smart public policy, private sector energy and community engagement. I’m referring to the Federal Community Reinvestment Act of 1977 – the CRA - which came into existence at a time when American banks were greenlining Latin America and redlining certain communities here at home. The CRA required lenders to maintain a continuing and affirmative obligation to help meet the credit needs of the communities they serve.

During the last 23 years, under the CRA, banks and savings and loans have committed more than $1 trillion in loans and investments in neighborhoods that were traditionally underserved.

The lending has spanned the range from small business to home mortgages to community redevelopment projects. Due in great part to the CRA, private sector home mortgage lending in low-and-moderate-income census tracts increased by 45 percent between 1993 and 1997, with a 72 percent increase in lending to African Americans. In fact, banks have experienced some of their greatest business growth in neighborhoods previously overlooked.

And have those loans proved to be risky? Federal Reserve Chairman Greenspan said in 1998 that there is, and I quote, “no evidence that banks’ safety and soundness have been compromised by (low-and-moderate-income) lending, and bankers often report sound business opportunities.”

Greenspan also said that the CRA – quote – “has helped financial institutions to discover new markets that may have been underserved before…”

And Greenspan’s observations were reinforced by a 1997 Federal Reserve Study that concluded that there was no statistically significant variation in profitability levels between banks that make high percentages of home loans to lower-income neighborhoods and those banks that make few such loans. The fact is that CRA-driven lending has proven to be profitable.

As I have pursued the goal of investing to hit the “double bottom line,” I’m discovering that it is possible to find investments that bring good returns and that advance the goals of environmental sustainability and equality of opportunity. Let me give you a few examples:

- Last year, the State Treasurer's Office increased by over $800 million its deposits in California community banks that make loans for homes and business development in our State. It was the right thing to do and the smart thing to do from both a policy and a fiduciary perspective.

  That's because, when we deposit money in California banks, we get a higher rate of return than we do if we're buying Treasury bills, the banks give us full collateral, and it diversifies our portfolio.

  One of the deposits that I like to point to is the $5 million we placed with Broadway Federal Bank that serves South Los Angeles making home and business loans in a community that desperately needs capital. We are creating economic activity at the same time we are making a secure investment.

- Here's another example of a "double bottom line" investment. The Treasurer's Office is purchasing $1 billion in home loans made under the CRA by California lenders to low and moderate income Californians and in low and moderate income neighborhoods. By doing that, we provide those lenders with new capital to lend again. Freddie Mac is backing the loans, and they're yielding a higher rate of return than the balance of our portfolio.

- Here's a third example. Last year, at my urging, CalPERS and CalSTRS committed $1 billion in new capital investment for urban, in-fill development - from mixed use to office to commercial to housing – targeted to California communities. These investments are designed to bring the funds market returns as we support smart growth with our State's investment capital.

Often there is a perception that these types of investments come with risks that exceed returns. However, there is increasing evidence – beyond the record of the Community Reinvestment Act – that capital can be successfully invested in ways that lift up our own struggling communities. For example, a recent HUD study found that the retail purchasing power of America's inner city markets exceeds by nearly $9 billion annually the retail sales in those markets. In Watts alone, the gap is nearly half a billion dollars – showing that retail investment is needed and can be successful.

A recent report to the State Teachers' Retirement Board by our professional real estate advisors also spoke to this matter. The report stated:

> "Due to market inefficiencies and negative perceptions, it appears that urban areas have been largely overlooked by mainstream investors including the traditional real estate advisory community, despite being attractive investment opportunities."

Here is a real life example of what I am talking about. A few years ago, Magic Johnson came to CalPERS and said he had an idea that a lot of our urban areas are lacking in retail stores and shops and services – despite strong demand. He proposed a venture to renovate and construct shopping centers in California's underserved, inner city communities.

So CalPERS has committed $100 million with his company. The investment is yielding a solid return of 9.6 percent and creating new wealth in communities historically bypassed by institutional capital.

- Here's a final example of a "double bottom line" investment. In 1998, CalPERS set aside $350 million for investment in venture capital. The results have been excellent. About 130 California-based, largely high-tech dot-com private companies have received start-up financing through this investment program. Ten of those are already public, with a combined market capitalization of $21 billion!

  The capital that CalPERS invested is helping build California's economic future. These companies are creating jobs, are environmentally clean, and they'll help sustain our State.

These investments are demonstrating that it is possible – with focus and effort – to shoot for the "double bottom line."

Now, I want to talk about the converse – investments which meet neither the test of sound fiscal policy nor the test of value to society.

In the same way that we need to open our eyes in the search for investments that yield good financial results as well as good results for society, we cannot be blinded to detrimental practices that result in poor financial returns. Nor should we fail to recognize that there is a correlation between the values of society and the value of investment.

A prime example of what I am talking about is investment in the tobacco industry.

In December, I decided, as manager of the State's short-term portfolio, that we would not purchase any more tobacco securities. My decision was based on a balancing of the risk and return of holding tobacco securities, in light of the fact that there are sound alternative investments available.

Stated a little differently, I made the decision, as a fiduciary, that tobacco securities are significantly risky investments because society as a whole has rendered a powerful judgment – unlikely to change anytime soon – about long standing industry practices and about the health impacts of tobacco products. That judgment has resulted in an exceptional and unparalleled level of legal and regulatory assault that already has adversely affected, and is likely to continue to affect, tobacco's investment performance.

I intend to ask CalSTRS and CalPERS to take similar action and to adopt tobacco free investment policies.

I want to make just a few more remarks about tobacco because this issue demonstrates so clearly that there are greater links between investment results and the values of society than are often acknowledged. Let's look at those links in the case of tobacco.

This industry has already settled for $246 billion in damages with 46 states.

The Investor Responsibility Research Center – the IRRC - reports that even this massive settlement didn't give tobacco immunity from punitive damage awards and class action lawsuits. And that's largely because a slew of additional incriminating documents were released as a condition of the Master Settlement Agreement, and that has opened the industry up to more lawsuits.

There's an ongoing class-action lawsuit in Florida that could result in a lump sum payment of hundreds of billions of dollars that could devastate U.S. tobacco companies. The U.S. Justice Department filed suit last September, asking for recovery of government funds spent on health insurance programs. Foreign litigation has ramped up and a French court has rendered the first foreign decision adverse to tobacco companies. And the FDA is pursuing jurisdiction to regulate nicotine.

Between September 1992 and September 1999, the S & P tobacco index underperformed the S & P 500 by more than 1000 basis points of annualized return – 7.69 percent versus 18.26 percent.

In 1999, performance of the large cap tobacco stocks was abysmal. The S & P 500 index posted gains of 21.2 percent, while Philip Morris had a one year return of minus 53.9 percent, U.S. Tobacco had a minus 22.4 percent return, and RJ Reynolds Tobacco posted a minus 41.7 percent return.

The 1999 performance of the tobacco industry had a marked impact on CalSTRS and CalPERS, resulting in estimated stock value losses of over $600 million.

Finally, I want to quote from the IRRC report, which points out that, and I quote, "fiduciaries do have a duty to be forward looking as they seek to secure the retirement incomes of future as well as present beneficiaries. This means that fiduciaries 'should take into account societal shifts that may affect investments over the long term, even if not in the short term."

So using the performance of our tobacco portfolio as a contrast with the "double bottom line" investments that I mentioned earlier, I think it is clear that there is a synergy between society's values and the value of investments. In other words, investments can and do affect society, and the forces of society can and do affect investments. And a good fiduciary never forgets that.

Let me give you another example of this dynamic. At the same time that we're struggling to get people to focus on sound investments we can make in California's economy, our pension funds have been investing in highly risky and volatile countries across the globe –

the so-called emerging markets. Between CalPERS and CalSTRS, we have about $5 billion invested in those overseas markets.

To restate something I said earlier, when we look at any investment, foreign or domestic, our first obligation is to make sure that we protect our pensioners' money. And if we're going to invest in volatile markets abroad, we'd better have a good handle on the risks. I've been concerned that we have been investing in countries where our returns have been troubled because we haven't fully understood the risks.

Recently, I was looking at CalPERS'returns over the last three years from some of these emerging markets. The fund experienced annualized losses in Indonesia of minus 29 percent; in Malaysia of minus 24 percent; and in Singapore of minus five percent.

The Treasurer's Office is preparing a proposal to CalPERS and CalSTRS, that will call for the two pension funds to raise the level of their screens before investing in some of these emerging markets. By "screens," I mean the standards for determining which emerging markets are appropriate for investment.

Interestingly enough, as we've done the research for this proposal over the last six months, we've asked ourselves and we've asked a lot of experts, "What makes for good long-term investments in developing and emerging markets?" And one answer that we hear consistently goes like this: Countries that do not move to free markets will never really achieve long-term economic growth.

A prerequisite to moving to free markets is developing a democratic society. So here is another correlation between good investment policy – making a sound investment from a fiduciary standpoint – and simultaneously investing in a way which supports quality of life in a society and which reinforces our society's values.

Indeed, Amartya Sen, the 1998 Nobel Laureate in economic science, stated, in his recent book, *Development As Freedom*:

> "There is strong evidence that economic and political freedom reinforce one another, rather than being hostile to one another."

In fact, when we examined this matter, we saw that the countries that are accepted as good financial risks are almost all democracies with freedom of the press, freedom of movement, and basic protections for workers. That's because these are essential ingredients to political stability and free markets. Indeed, there's a high correlation between democratic societies and a low investment risk level. Conversely, there is a strong correlation between the lack of freedom and high investment risk.

Ninety-four percent of the countries rated as "free" by the well respected, bipartisan Freedom House are rated as very low or low risk for investment purposes by the International Country Risk Guide. Seventy-five percent of the countries which have received "not free" ratings were rated as moderate, high, or very high risk.

As we all know, in this country, we take for granted as essential the concept of "transparency," -- meaning that the investor and the public should know as much as possible about companies in which they're investing. That's why freedom of the press is so important. If you have a country in which there's no freedom of the press, how do investors, particularly those who are halfway around the world, make a reasonable judgment about what's happening in that country and what they ought to be doing or not doing with their investments?

The screens we will be proposing to CalPERS and CalSTRS recognize the relationship of essential freedoms to economic stability and development. The screens will protect our pension funds and, incidentally, invest our monies in a way which supports the very values of freedom which we embrace as a society.

We don't need to support bad practices and values in a world of better choices.

There will be those who argue that what I am advocating here today is a step down the proverbial "slippery slope." However, failure to take into account political and societal factors can be an act of fiduciary blindness. Furthermore, there is nothing slippery about striving to manage capital in a way that is financially successful and beneficial for our society.

Now we've covered a lot of ground today in this discussion. And I'd would like to wrap up by saying again that first and foremost, and without equivocation, those of us who invest money have an absolute and unmitigated responsibility to meet our fiduciary duties and to achieve good and solid returns.

There is a world, a universe, of investment choices. What we ought to be on, it seems to me, is a constant search for the ones that meet that first test – good returns, -- but which also build up our economy and society.

The notion that we should strive to invest in a way that is financially successful and good for our society should hardly be considered radical. After all, as a society, we have the expectation that corporations should not only be profitable, but also should produce products of quality and conduct themselves well.

Indeed, the ideal private sector enterprise is one that excels on both fronts. We value the real estate development firm which builds profitable, quality projects which enrich our communities. We respect the successful technology company which creates value for shareholders and innovations for the next century.

Why should we hold capital -- and ourselves – to a lesser standard?

I will close with a quote from Felix Rohatyn, the current Ambassador to France who most of you know as a highly respected investment expert. He said:

> "There is no contradiction between the fiduciary responsibility of a pension fund manager and the social responsibility of a public official."

Those of us entrusted with managing the capital of this nation have a serious responsibility to those whose life savings are entrusted to us and to the society of which we are a part. Striving to meet the both obligations should be our “double bottom line”.

Thank you for giving me this opportunity to discuss these issues with you today.